Franchise Tax Board

ANALYSIS OF AMENDED BILL

Author:	Machado	Analyst:	Garnier	Bill Number:	AB 2797
Related Bills:	SB 1496 (1998) AB 1779 (1998)	Telephone:	845-5322	Amended Date:	8-10-98
		Attorney:	Doug Bramhall	Sponsor:	

SUBJECT: Budget Trailer\Conformity Act of 1998

____	DEPARTMENT AMENDMENTS ACCEPTED. Amendments reflect suggestions of previous analysis of bill as introduced/amended _________.
X	AMENDMENTS IMPACT REVENUE. A new revenue estimate is provided.
____	AMENDMENTS DID NOT RESOLVE THE DEPARTMENT'S CONCERNS stated in the previous analysis of bill as introduced/amended _________.
____	FURTHER AMENDMENTS NECESSARY.
____	DEPARTMENT POSITION CHANGED TO _______________________.
____	REMAINDER OF PREVIOUS ANALYSIS OF BILL AS INTRODUCED/AMENDED ___________ STILL APPLIES.
X	OTHER - See comments below.

SUMMARY OF BILL

This bill would make several changes to the income tax laws:

I. RENTER'S CREDIT MODIFICATION (page 3)

This provision would amend the existing renter's credit to allow a credit amount of $120 for married filing joint returns, heads of household and surviving spouses if adjusted gross income is $50,000 or less, and $60 for other individuals (single or married filing separate) if adjusted gross income is $25,000 or less. This provision would make the renter's credit nonrefundable.

This provision also would require the Franchise Tax Board (FTB) to recompute the adjusted gross income amounts annually for inflation.

II. HOMEOWNERS AND RENTERS ASSISTANCE PROGRAM (page 5)

This provision would adjust for inflation, from 1977 to present and then annually from 1998, the household income amounts used to determine eligibility and the amount of assistance for claimants of the Homeowners and Renters Assistance program.

III. DEPENDENT EXEMPTION CHANGES (page 7)

This provision would increase the dependent exemption credit from $120 to $253 in 1998 and from $222 to $227 in 1999 and index this latter amount for inflation thereafter.

Board Position:			Department Director	Date
____ S	____ NA	____ NP		
____ SA	____ O	____ NAR		
____ N	____ OUA	X PENDING	John W. Davies	9/17/98

C:\WINDOWS\TEMP\AB 2797 8-10 BA8F.DOC
09/17/98 4:39 PM

LSB TEMPLATE (rev. 6-98)

IV. JOINT STRIKE FIGHTER PROGRAM CREDITS (page 8)

This provision would create a wage credit and property credit for the Joint Strike Fighter (JSF) program. These credits would apply to taxpayers under initial contract or subcontract to manufacture property for ultimate use in a JSF.

V. FEDERAL CONFORMITY (page 14)

The Personal Income Tax Law (PITL) and the Bank and Corporation Tax Law (B&CTL), in general, conform to the Internal Revenue Code (IRC) either by incorporating the IRC by reference as of a "specified date" or by stand alone language which mirrors the federal provision. California law is conformed to the IRC as of January 1, 1997, unless a specific provision provides otherwise. This bill would change the specified date from January 1, 1997, to January 1, 1998, for taxable and income years beginning on or after January 1, 1998.

SUMMARY OF AMENDMENT

Prior to the August 10, 1998, amendment, this bill contained only intent language to make the necessary statutory changes to implement the Budget Act of 1998 relative to taxation. The August 10, 1998, amendment replaced the intent language with language providing for the above listed provisions.

The report will not address the bill's other provisions which do not impact the department or state income tax revenue.

EFFECTIVE DATE

Unless otherwise specified, this bill would apply to taxable and income years beginning on or after January 1, 1998.

SPECIFIC FINDINGS

FISCAL IMPACT ON STATE BUDGET

Revenue losses for this bill over the initial three-year period are projected as follows:

Fiscal Year Cash Flow Impact $ millions			
	1998-99	1999-00	2000-01
Renter's Credit *	($133)	($141)	($144)
Homeowners and Renters Assist.		($71)	($73)
Dependent Exemption Changes	($612)	($22)	($23)
Joint Strike Fighter Credits			($5)
Federal Conformity	($34)	($29)	($32)
TOTAL	**($779)**	**($263)**	**($277)**

* The renter's credit revenue loss is based on the Governor's proposed budget which assigned a zero cost to the program.

I. RENTER’S CREDIT MODIFICATION.

Background

Since the inception of the Renters' Credit Program in 1972, the amount of the renters' credit, at various times, has been increased, decreased, and phased-out based on a taxpayer's income.

As originally enacted, the renters' credit was based on adjusted gross income, the purpose being to provide a larger proportion of benefit to lower income renters.

Specific Findings

Current state law allows qualifying renters a refundable credit of $60 or $120, based on filing status. The credit is not related to the amount of rent paid. The renters’ credit has been suspended for the 1993 through 1997 tax years, but by statute is reinstated effective January 1, 1998, for the 1998 taxable year.

Current state law defines a "qualified renter" as an individual who:

- is a California resident, and
- rented and occupied California premises constituting his or her principal place of residence for at least 50% of the taxable year.

In **current state law**, the term "qualified renter" does not include individuals:

(1) who for more than 50% of the taxable year rented and occupied premises which were exempt from property taxes (subject to certain exceptions);

(2) whose principal place of residence for more than 50% of the taxable year is with any other person who claimed that individual as a dependent for income tax purposes; or

(3) who have been granted or whose spouse has been allowed the homeowners' property tax exemption during the taxable year, as specified.

Under **current state law**, if the renter has a tax liability below the allowed amount of renters' credit, or no tax liability at all, the renter receives a refund check for the remaining "unused" credit.

The Revenue and Taxation Code defines a "resident" as:

(1) Every individual who is in this state for other than a temporary or transitory purpose.

(2) Every individual domiciled in this state who is outside the state for a temporary or transitory purpose.

In **current state law**, any qualified renter who is a nonresident for a portion of the taxable year is allowed 1/12 of the renter’s credit for each full month that the individual resided in the state for the taxable year, once the requirement of renting in California for more than 50% of the taxable year has been met.

This provision would amend the existing renters' credit to allow a credit amount of $120 for married filing joint returns, heads of household and surviving spouses if adjusted gross income is $50,000 or less, and $60 for other individuals (single or married for separate) if adjusted gross income is $25,000 or less. This provision would make the renter's credit nonrefundable.

This provision also would require the FTB to recompute the adjusted gross income amounts annually for inflation.

Implementation Considerations

Changes required by this provision would be performed during the department's annual update process.

Technical Considerations

When the law was modified to make the credit non-refundable, language was unintentionally not stricken that affects how the credit is applied. Additionally, because the credit would be non-refundable and could not be carried forward the law section that specifies in which order credits are applied should have been amended. Presently, the credit would be applied after all other credits that may be carried forward, thus, limiting the renter's credit benefits to some taxpayers. Amendments have been proposed and accepted by the author. Technical amendments have been made in SB 2234, which is enrolled and is expected to be signed into law by the Governor.

Fiscal Impact

Departmental Costs

Departmental costs are not expected to be significant.

Tax Revenue Estimate

Revenue losses, based on the Governor's budget, under the Personal Income Tax Law (PITL) are estimated as follows:

Effective Beginning on or After January 1, 1998 (in millions)				
1998-9	1999-0	2000-1	2001-2	2002-3
($133)	($141)	($144)	($147)	($150)

The Governor's proposed budget indicates the cost of the Renter's Credit Program as zero. Therefore, based on the Governor's proposed budget this bill would have revenue losses as estimated above. However, generally such changes are indicated as compared to current law. In that case, this provision would result in a revenue gain of $406 million in 1998-99.

Tax Revenue Discussion

Revenue losses under the PITL would depend on the number of eligible renters who would qualify for the $60 single, married filing separate/$120 joint, head of household credit amounts with adjusted gross incomes less than $25,000 single, married filing separate/$50,000 joint, head of household (adjusted gross incomes indexed thereafter).

For the 1998 tax year approximately 1.8 million filers will benefit from tax reductions as a result of this change. Estimates reflect interaction with dependent exemption increases.

II. HOMEOWNERS AND RENTERS ASSISTANCE PROGRAM.

Background

Since 1968, California has provided relief to senior citizens in the form of property tax assistance. In 1977, the program was extended to renters and was based on a property tax equivalent amount estimated to be paid by renters. Beginning in 1979, totally disabled homeowners and renters, regardless of age, became eligible for the program. This program is called Homeowners and Renters Assistance (HRA) and is administered by the FTB.

Specific Findings

The assistance amount under the HRA program represents a partial reimbursement of the previous fiscal year's property taxes on personal residences paid directly by homeowners and indirectly by renters. For renters, a payment of $250 in property tax is assumed. Relief for homeowners and renters is based on a percentage of the property tax. This percentage varies inversely to the applicants' income levels and ranges from 4% to 96%.

To be eligible for assistance, the claimant's total household income for the prior calendar year cannot exceed $13,200. Total household income consists of adjusted gross income (as computed for tax purposes) increased by nontaxable income including social security, cash public assistance, pensions and annuities (not otherwise taxable), unemployment insurance, tax-exempt interest, life insurance proceeds, gifts in excess of $300, and worker's compensation payments. Also, the gross household income cannot exceed $24,000. Gross household income is total household income plus all non-cash business expenses such as depreciation, amortization, and depletion.

Claimants may file for assistance from May 15 through August 31, inclusive. However, the FTB may accept claims through June 30 of the year following that for which assistance is claimed, given certain extenuating circumstances such as documented medical disability during the normal filing period. It takes up to 15 weeks to process a claim.

This provision would require that all income levels eligible for assistance under current law be multiplied by 2.51 for assistance provided for the 1999 calendar year, making the maximum total household income eligible for assistance $33,132. The 2.51 multiplier represents the increase in inflation since 1977 (less a minor augmentation that occurred to the HRA Program in 1989). These provisions also would require annual inflation adjustments, based upon changes in the Consumer Price Index (CPI).

This provision would require the California Department of Industrial Relations (DIR) to transmit to the FTB on or before February 1 of each year the percentage change in the California CPI for all items from June of the second preceding calendar year to June of the immediately preceding calendar year.

This provision would apply inflation adjustment factors to both the gross household income limit and the total household income limit of the HRA program. The inflation adjustment would be based upon the percentage change in the California CPI for all items.

This provision would be effective January 1, 1998, and specifies that it would be operative with respect to assistance provided for the 1999 calendar year.

Implementation Considerations

Changes required by this provision would be performed during the department's annual update process.

Fiscal Impact on State Budget

Departmental Costs

Commencing in 1999, there would be an additional cost to the department of approximately $600,000 annually for processing an estimated additional 220,000 HRA returns. These costs do not consider the impact of Title IV of the Personal Responsibility and Work Opportunity Reconciliation Act of 1996.

Tax Revenue Estimate

It is estimated that these provisions would result in revenue losses as shown in the following table:

Revenue Impact of Indexing HRA for Renters and Homeowners Effective Beginning on and After June 30, 1999 $ Millions				
	1998-9	1999-0	2000-01	2001-02
Renters	0	($66)	($68)	($71)
Homeowners	0	($ 5)	($ 5)	($ 5)
TOTAL	$0	($71)	($73)	($76)

This estimate does not take into account any change in employment, personal income, or gross state product that might result from this bill becoming law.

Tax Revenue Discussion:

The revenue impact of this bill would depend on the number and income distribution of qualified claimants. This estimate was based on historical data for the current HRA program extrapolated to match census data and return information for the additional residents (homeowners and renters) who would qualify under the newly proposed income limits. Approximately 18,000 California homeowners and 135,000 renters filed for property tax assistance amounting to approximately $14 million for calendar year 1996.

This bill would increase assistance payments the first year (1999-0) by $5 million for an estimated 35,000 homeowners (existing and new claimants) and $66 million for an estimated 350,000 renters (existing and new claimants).

III. DEPENDENT EXEMPTION CHANGES.

Specific Findings

Existing **federal law** provides various personal and dependent exemptions subject to certain income limitations. These exemptions are treated as deductions from adjusted gross income (AGI). The exemption deduction amount is indexed annually for inflation and is $2,583 for the 1997 tax year. Exemption deductions begin to phase out at federal AGI levels over specified amounts, which are the same amounts as those for state law noted below.

The **Taxpayer Relief Act of 1997** (TRA of 1997) provides a child tax credit of $400 for 1998 and $500 for 1999 and each year thereafter for each qualifying child. “Qualifying child” is defined as any individual (1) for whom the taxpayer is allowed the dependent exemption deduction, (2) who is under the age of 17, and (3) who bears the same relationship to the taxpayer as that required under the relationship test for the federal earned income credit. “Qualifying child” does not include individuals who are not citizens or nationals of the United States unless they are a resident of the United States. This child tax credit is phased out for taxpayers with adjusted gross income above specified levels. For taxpayers with three or more qualifying children, the credit is limited to the greater of (1) the excess of regular tax over tentative minimum tax, or (2) the alternative credit amount, as defined. Any credit amount in excess of these limitations, reduced by the amount of alternative minimum tax paid, will be refunded to the taxpayer.

Existing **state law** provides various exemption credits against tax, including a personal exemption and exemptions for dependents, blind persons, and individuals 65 or older. Unlike federal law, these exemptions are not deductions from AGI but are credits against tax. The exemption credit amount is indexed annually for inflation as measured by changes in the California CPI. The exemption credit amount for the 1997 tax year is $68. To compute exemption credits, the total number of exemptions claimed is multiplied by the exemption credit amount (total number of exemptions x $68 = exemption credit). Exemption credits are not refundable and may not be carried over to future years. Current **state law** provides a dependent credit of $120 for 1998 and $222 for 1999.

Existing **state law** provides two limitations on exemption credits:

1. Exemption credits begin to phase out at federal AGI levels over the amounts listed below:

Filing Status	AGI (1997)
Single/Married Filing Separate	$114,152
Head of Household	$171,228
Married Filing Joint	$228,305

2. Exemption credits are limited to the amount by which regular tax before credits exceeds tentative minimum tax (TMT).

This provision would increase the dependent exemption credit amount from $120 to $253 for the 1998 taxable year and from $222 to $227 for the 1999 taxable year and thereafter. The increased credit for the 1999 taxable year would be adjusted for inflation after the 1999 taxable year. These increased credit amounts would continue to be subject to the above limitations.

Implementation Considerations

Changes required by this provision would be performed during the department's annual update process.

Fiscal Impact on State Budget

Departmental Costs

The provisions of this bill would not significantly impact the department's costs.

Tax Revenue Estimate

Revenue losses under the Personal Income Tax Law are estimated as follows:

Effective Beginning on or After January 1, 1998 (in millions)				
1998-9	1999-0	2000-1	2001-2	2002-3
($612)	($22)	($23)	($24)	($25)

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

Revenue losses under the PITL would depend on the number of taxpayers who would be eligible to deduct the increased dependent exemption credit amounts ($253 per dependent for 1998, $227 for 1999, and indexed thereafter).

The above estimates are based on the department's personal income tax model. For the 1998 tax year approximately 3 million tax returns will benefit from tax reductions as a result of this change.

IV. JOINT STRIKE FIGHTER PROGRAM CREDITS.

Background

The JSF Program is the Department of Defense's focal point for defining "affordable next generation strike aircraft weapon systems" for the Navy, Air Force, Marines, United Kingdom Royal Navy and other U.S. allies. The focus of the program is affordability -- reducing the development cost, production cost, and cost of ownership of the JSF family of aircraft.
There are five phases to the program, the Concept Exploration Phase (completed), the Concept Development Phase (completed), the Concept Demonstration Phase (fiscal years 1997 - 2000), the Engineering and Manufacturing Development Phase (fiscal years 2001 - 2007), and the Production Phase (fiscal years 2008 and after).

The Concept Exploration Phase concluded that a “family of aircraft” should be developed to meet tri-service needs. The “family of aircraft” concept would meld the operational and technological requirements of all armed services into highly common (up to 90% common) aircraft. Additional systems and components could be added to the common aircraft (aircraft variants) to satisfy unique service needs. A highly common aircraft should reduce manufacturing and assembly costs. In addition, it should extend the operational life of the aircraft.

The Concept Development Phase focused on (1) developing aircraft system designs that take advantage of the “family of aircraft” concept and (2) defining the necessary leveraging technology demonstrations that will lower risk prior to entering the Engineering and Manufacturing Development Phase.

The Concept Demonstration Phase commenced in fiscal year 1997 following a competitive process reducing three weapon system concept teams to two. This phase will feature flying concept demonstrators, concept-unique ground and flight demonstrations, and continued refinement of the contractors’ preferred weapon system concepts.

This phase is budgeted at $2.2 billion, including propulsion efforts funded under a separate contract. The Boeing Company was awarded a $662 million cost-plus-fixed-fee contract and Lockheed Martin Corporation was awarded a $719 million cost-plus-fixed-fee contract. The Boeing Company contract is expected to be performed in Seattle, Washington. The Lockheed Martin Corporation contract is expected to be performed in Palmdale, California (71%), and Fort Worth, Texas (29%). Contracts also were awarded to Pratt and Whitney to provide hardware and engineering support for the Weapon System Concept Demonstration efforts and to General Electric for the propulsion.

The Engineering and Manufacturing Development Phase is planned for fiscal year 2001. The first delivery of operational aircraft is anticipated in fiscal year 2008. The Production Phase is planned for fiscal year 2008.

The U.S. armed forces will need as many as 3,000 JSFs to replace several different aircraft in service today. The potential export market for the JSF is estimated to be very large.

Specific Findings

Existing **state and federal laws** generally allow a depreciation deduction for the obsolescence or wear and tear of property used in a business or as investment property. The property must have a limited, useful life of more than one year and includes equipment, machinery, vehicles and buildings but excludes land. Property is assigned to specific classifications related to the number of years of its useful life. The property then may be depreciated over the number of years of its useful life (recovery period).

Existing **state and federal laws** allow a taxpayer to deduct expenses paid or incurred in the ordinary course of a taxpayer’s business (e.g., employee wages and benefits).

Existing **state law** allows taxpayers to use various credits against tax such as the Manufacturers' Investment Credit (MIC) and economic development area[1] sales or use tax credits and hiring credits.

Manufacturers' Investment Credit (MIC)

The MIC allows qualified taxpayers a credit equal to 6% of the amount paid or incurred after January 1, 1994, for qualified property that is placed in service in California. A qualified taxpayer is any taxpayer engaged in manufacturing activities described in specified codes in the Standardize Industrial Codes (SIC) Manual. Qualified property is any of the following:

1) Tangible personal property that is defined in Section 1245(a) of the Internal Revenue Code and used primarily:

for manufacturing, processing, refining, fabricating or recycling of property;
for research and development;
for the maintenance, repair, measurement, or testing of otherwise qualified property; or
for pollution control which meets or exceeds state or local standards.

2) The value of any capitalized labor costs directly allocable to the construction or modification of the property listed in #1 above or for special purpose buildings and foundations listed in #3 below.

3) Special purpose buildings and foundations that are an integral part of manufacturing, refining, processing or fabricating, or research and storage facilities that are part of the process, which are used by qualified persons performing manufacturing activities described in specific codes relating to computer, accounting, and office machines, electronic equipment and accessories, biotech or biopharmaceutical activities, semiconductor equipment manufacturing activities and certain aerospace manufacturing activities.

The MIC explicitly excludes certain types of property from the definition of qualified property, including equipment used in the extraction process, furniture, facilities used for warehousing purposes after completion of the manufacturing process, inventory, equipment used to store finished products that have completed the manufacturing process, and tangible personal property used in administration, general management, or marketing.

The MIC provides a variety of special rules for costs paid pursuant to a binding contract and leased property. The credit may be carried over until exhausted, for a maximum of eight years. For small businesses, this carryover period is extended to ten years. The taxpayer must recapture any credit previously allowed if the property is removed from California, disposed of to an unrelated party or converted to an unauthorized use within one year from the date the property is first placed in service in California.

---

[1] Economic development areas include Enterprise Zones, the Los Angeles Revitalization Zone (LARZ), Local Agency Military Base Recovery Areas (LAMBRAs), Targeted Tax Areas (TTAs) and Manufacturing Enhancement Areas (MEAs).

The MIC will become inoperative on January 1, 2001, or on January 1 of the earliest year after 2001 if the total employment in manufacturing in this state does not exceed by 100,000 jobs the total employment in manufacturing in this state on January 1, 1994. The Employment Development Department (EDD) is required to report to the Legislature annually on this determination.

Sales or Use Tax Credit

The sales or use tax credit is allowed for an amount equal to the sales or use taxes paid on the purchase of qualified property for exclusive use in an economic development area (except an MEA). The amount of the credit is limited to the tax attributable to economic development area income. Qualified property is defined as follows:

Enterprise Zone:
machinery and machinery parts used to:
manufacture, process, combine, or otherwise fabricate a product;
produce renewable energy resources; or
control air or water pollution.
LAMBRA:
high technology equipment (e.g., computers);
aircraft maintenance equipment;
aircraft components; or
certain depreciable property.
LARZ:
building materials used to replace or repair the business's building and fixtures; and
machinery or equipment, excluding inventory.
TTA:
machinery and machinery parts used to:
manufacture, process, combine, or otherwise fabricate a product;
produce renewable energy resources;
control air or water pollution;
data process and communications; or
manufacture motion pictures.

In addition, qualified property must be purchased and placed in service before the economic development area designation expires. The maximum value of property that may be eligible for the enterprise zone, LAMBRA, and TTA sales or use tax credit is $1 million for individuals and $20 million for corporations. No such limitation exists for the LARZ sales or use tax credit. If a taxpayer cannot use the full amount of credit allowable in any one year, the taxpayer may carryover the remainder of the credit for use in subsequent tax years, including those years after the designation has expired, until all of the credit is used.

Hiring Credits

A business located in an economic development area may reduce tax by a percentage of wages paid to qualified employees. A qualified employee must be hired after the area is designated as an economic development area and must meet certain other criteria. At least 90% of the qualified employee's work must be directly related to a trade or business located in the economic development area and at least 50% must be performed inside the economic development area.

The taxpayer may claim as a credit up to 50% of the wages paid to a qualified employee against tax imposed on economic development area income. The credit is based on the lesser of the actual hourly wage paid or 150% of the current minimum hourly wage (202% of the minimum wage for certain aircraft manufacturer employees within the Long Beach Enterprise Zone). The amount of the credit must be reduced by any other federal or state jobs tax credits and the taxpayer's deduction for ordinary and necessary trade or business expenses must be reduced by the amount of the hiring credit.

Certain criteria regarding who may be qualified employees and certain other limitations differ between the various economic development areas. For the LARZ, an additional construction hiring credit is available: a taxpayer with a business located in a LARZ may claim as a credit against tax imposed on LARZ income 50% to 100% of the wages paid to a qualified construction employee. The actual percentage depends upon the date the employee was hired.

If a taxpayer cannot use the full amount of credit allowable in any one year, the taxpayer may carry over the remainder of the credit for use in subsequent tax years, including those years after the designation has expired, until all of the credit is used.

The **JSF provisions** would create a wage credit and a property credit for the JSF program. These credits would apply to taxpayers under initial contract or subcontract to manufacture property for ultimate use in a JSF. The credits would be available for taxable years beginning on or after January 1, 2001, and before January 1, 2006. Any excess credit could be carried forward for up to eight years. No credit would be allowed unless the bid upon which the JSF contract or subcontract is based is reduced by the credit amount. The taxpayer would be required to provide, at the request of the Franchise Tax Board, all references to the credit and ultimate cost reductions incorporated into any successful bid that was awarded a JSF contract or subcontract.

The wage credit would be equal to a specified percentage (50% for 2001, 40% for 2002, 30% for 2003, 20% for 2004 and 10% for 2005) of employee wages that are treated as direct costs under Section 263A of the Internal Revenue Code (IRC) allocable to property manufactured in this state for ultimate use in a JSF. The wages could be paid to new or existing employees whose services for the taxpayer are at least 90% directly related to the contract or subcontract to manufacture property for ultimate use in a JSF. The credit would be limited to $10,000 per year, per employee, and be prorated for partial years.

The property credit is generally patterned after the MIC. It would be equal to 10% of the cost of qualified property. Qualified property would mean tangible personal property (IRC Section 1245(a)(3)(A)), and capitalized labor costs that are treated as direct costs under Section 263A of the IRC allocable to that property, used by a taxpayer primarily in activities to manufacture a product for ultimate use in a JSF.

Certain types of property would be excluded from the definition of qualified property, including furniture, inventory, equipment used to store finished products that have completed the manufacturing process, and tangible personal property used in administration, general management, or marketing. The bill would provide special rules for costs paid pursuant to a binding contract and leased property.

The credit would be recaptured if, within one year of being placed in service, the property is sold, moved out of state or used for purposes other than manufacturing a product for ultimate use in a JSF.

The taxpayer would not be allowed this credit and the MIC for the same property.

These provisions specify that the credits would **be operative** for taxable or income years beginning on or after January 1, 2001, and before January 1, 2006.

Implementation Considerations

This bill would require the taxpayer to be under “an initial” contract or subcontract to manufacture property for ultimate use in a JSF. It is unclear whether an “initial contract” could include modifications to that contract. This could lead to disputes between taxpayers and the department. Clarifying legislation may be required.

Fiscal Impact on State Budget

Departmental Costs

This bill would not significantly impact the department’s costs.

Tax Revenue Estimate

Revenue losses for this provision over the initial three-year period are projected to be as follows:

Fiscal Year Cash Flow Impact $ Millions					
	1998-98	1999-00	2000-01	2001-02	2002-03
Property	0	0	(1)	(7)	(8)
Wages	0	0	(4)	(54)	(56)
Total	$0	$0	(5)	(61)	(64)

This analysis does not take into account any change in employment, personal income, or gross state product that may result from this bill becoming law.

Tax Revenue Discussion

This revenue estimate depends on the value of investment and wages paid in California as part of the JSF project. This estimate assumes that the credits could be claimed in the year in which the federal government disburses money under the JSF program. These credits would be available only for JSF contracts and subcontracts that specifically reflect the use of these credits in the bid.

These credits would apply to the Engineering and Manufacturing Development phase of the JSF program. Expenditures for this phase are expected to be $875 million in 2001 (*Joint Strike Fighter Program Master Plan 1996*). This estimate assumes that the same amount would be spent in each of the following years. The estimate assumes that approximately 70% of the work on the JSF project will be performed in California, this is based on information in *Department of Defense Press Releases* regarding contracts awarded under the concept demonstration phase of the JSF project.

Other assumptions include:

40% of all JSF contracts will be spent on qualified investments.

40% of all JSF contracts will be spent on wages of qualified employees. In addition, 40% of subcontracts for qualified investments would be spent on wages of qualified employees. However, since the credit is limited to $10,000 per employee, it is estimated that the wage credit would be approximately 25% of total wages in 2001. As the structure of the credit changes, the credit as a percentage of total wages declines to just under 10% by 2005.

50% of credits would be used in the year in which they are generated because of alternative minimum tax limitations. The numbers in the table reflect credits used.

V. FEDERAL CONFORMITY.

Specific Findings

These provision would change the specified date from January 1, 1997, to January 1, 1998, for taxable and income years beginning on or after January 1, 1998. Changing the specified date automatically conforms to all changes from January 1, 1997, through December 31, 1997, to IRC sections that have been previously incorporated by reference. Thus, California law would conform to most of the changes made to the federal income tax by the TRA of 1997.

These provisions also would make numerous changes to specifically not conform or modify certain items in the IRC. Additionally, numerous technical changes regarding cross references and the deletion of unnecessary language that was used to conform to federal law changes subsequent to January 1, 1997, and prior to January 1, 1998, are being made by this bill.

The changes that would be made to California tax law by this bill, are outlined as follows:

1. Creation of Medicare+Choice Medical Savings Accounts.
2. Hospitals Participating in Provider-Sponsored Organizations.
3. Deduction for Student Loan Interest.
4. Modifications of Qualified State Tuition Programs.

5. Enhanced Deduction for Corporate Contributions of Computer Technology.
6. Treatment of Cancellation of Certain Student Loans.
7. Repeal the Depreciation Adjustment for Alternative Minimum Tax.
8. Repeal of Throwback Rules Applicable to Domestic Trusts.
9. Home Office Deduction: Clarification of Definition of Principal.
10. Expensing of Environmental Remediation Costs ("Brownfields").
11. Shrinkage Estimates for Inventory Accounting.
12. Timeshare Associations.
13. Increased Deduction for Business Meals for Individuals under Department of Transportation Limitations.
14. Deductibility of Meals Provided for the Convenience of the Employer.
15. Modify Limits on Depreciation of Luxury Automobiles for Clean-Burning Fuel and Electric Vehicles.
16. Suspension of Income Limitations on Percentage Depletion for Production from Marginal Wells.
17. Increase in Standard Mileage Rate for Purposes of Computing Charitable Deduction.
18. Purchasing of Receivables by Tax-Exempt Hospital Coop. Organizations.
19. Provide Above-the-Line Deduction for Certain Business Expenses.
20. Required Recognition of Gain on Certain Appreciated Financial Positions in Personal Property.
21. Election of Mark-to-Market for Securities and Commodities Traders.
22. Limitation on Exception for Investment Companies under IRC Section 351.
23. Gains and Losses from Certain Terminations with Respect to Property.
24. Determination of Original Issue Discount Where Pooled Debt Obligations are Subject to Acceleration.
25. Deny Interest Deduction on Certain Debt Instruments.
26. Require Gain Recognition for Certain Extraordinary Dividends.
27. Require Gain Recognition on Certain Distributions of Controlled Corporation Stock (Morris Trust Transaction).
28. Reform Tax Treatment of Certain Corporate Stock Transfers.
29. Treat Certain Preferred Stock as "Boot".
30. Modify Holding Period for Dividends-Received Deduction.
31. Reporting of Certain Payments Made to Attorneys.
32. Returns of Beneficiaries of Estates and Trusts.
33. Registration and Penalties For Confidential Corporate Tax Shelters.
34. Extend UBIT Rules to Second-Tier Subsidiaries and Amend Control Test.
35 Allocation of Basis Among Properties Distributed by Partnership.
36. Repeal of Requirement Inventory be Substantially Appreciated with Respect to Disposition of Partnership Interest.
37. Extension of Time for Taxing Pre-Contribution Gain.
38. Cashout of Certain Accrued Benefits.
39. Taxable Cash Compensation in lieu of Nontaxable Parking Benefits.
40. Basis Recovery Rules for Annuities Over More Than One Life.
41. Denial of Deduction for Certain Amounts Paid in Connection with Insurance.
42. Limitation on Property for which Income Forecast Method May be Used.
43. Involuntarily Converted Property Acquired from an Unrelated Person.
44. Exception from Installment Sales Rules for Sales by a Manufacturer.
45. Limitations on Charitable Remainder Trust Eligibility.
46. Estimated Tax Requirements of Individuals.
47. Simplify Treatment of Personal Transactions in Foreign Currency.
48. Simplify Formation and Operation of International Joint Ventures.
49. Increase Standard Deduction and AMT Exemption Amount for Kiddie Tax.
50. Increase Amount of Tax Exempt from Estimated Tax Requirements.

51. Treatment of Certain Reimbursed Expenses of Rural Mail Carriers.
52. Travel Expenses for Certain Federal Employees.
53. Modifications to Look-Back Method for Long-Term Contracts.
54. Treatment of Construction Allowance Provided to Lessee.
55. Closing of Partnership Year with Respect to Deceased Partner.
56. Provide Additional Exceptions for Reasonable Cause for Penalties.
57. Clarification of Statute of Limitations for Pass-Through Entity Items.
58. Items Relating to Income Taxation of Estates.
59. Certain Notices Disregarded Under Provision Increasing Interest Rate on Large Corporate Underpayments.
60. Pension Simplification Provisions.
61. Miscellaneous Provisions Relating to Pensions and Other Benefits.
62. Modification to Minimum Tax Depreciation Rules.
63. Technical Changes.
64. Treatment of Worker's Compensation Liability under Rules for Certain Personal Injury Liability Assignments.
65. Exclusion from UBIT for Certain Corporate Sponsorship Payments.
66. Conformity to 1995 ESOPs provisions.
67. Increase in Self-Employed Health Insurance Deduction.
68. S Corporations Elections.

Items 66 through 68 will be discussed in this analysis. Items 1 through 65 have been discussed in detail in the bill analysis for SB 1496 as amended on April 20, 1998 and/or July 19, 1998.

Specific Findings

66. Conformity to 1995 Employee Stock Ownership Plans (ESOPs) provisions.

Existing **federal law** provides special tax rules for the purchase of employer securities by the employees of the issuing company. These special tax rules are as follows:

- The employer corporation is entitled to a deduction for dividends paid to the ESOP, provided that amount is in turn paid by the ESOP to its participants or used to repay an ESOP loan. Contributions by the employer to an ESOP that are used to repay loans incurred to purchase employer stock may be deducted as long as they do not exceed 25% of the total compensation paid to participants.

- When the stock of a domestic corporate employer is closely held (that is, the corporation has no stock outstanding that is readily tradable on an established securities market), federal law allows shareholders to sell the stock to an ESOP and to roll-over the gain into other corporate stock acquired with the proceeds from the sale. Gain may be deferred in this manner so long as immediately after the sale to the ESOP, the ESOP owns at least 30% of the closely held employer's stock and within 15 months the seller purchases "qualified replacement securities" (which include stock, stock rights, bonds and debentures) in a domestic corporation. This deferral does not apply to gain includible in the gross income of any C corporation.

The **state provisions** that conformed to these two rules apply only to taxable (and income) years beginning before January 1, 1995, and on or after January 1, 1996. Therefore, there is no special treatment in current state law with respect to ESOPs for taxable or income tears beginning in 1995.

This provision would conform state law to federal law for taxable and income year beginning in 1995, thus filling the gap in conformity.

67. Increase in Self-Employed Health Insurance Deduction.

Existing **federal law** provides for a deduction in determining AGI of 45% (effective for 1998) of a self-employed individual's cost for health insurance. Federal law also allows the deductible percentage to incrementally increase to 100% beginning in the year 2007. The percent is increased as follows:

45% in 1998 and 1999,
50% in 2000 and 2001,
60% in 2002,
80% in 2003 through 2005,
90% in 2006, and
100% in 2007 and thereafter.

Prior to the enactment of the TRA of 1997, the federal deductible percentage increased from 25% in 1996 to 80% in 2006. The 1997 federal deduction was 40%.

For taxable years beginning in 1997, the deductible percentage for self-employed health insurance costs, **under California law**, was 40% (SB 455, Stat. 1997, Ch. 611). For taxable years beginning on or after January 1, 1998, the California percentage reverts to the pre-1997 percentage of 25% (SB 1233, Stat. 1997, Ch. 612).

Under both federal and state law, the cost of health insurance incurred by a self-employed individual that is not deductible in determining AGI may be taken as an itemized medical deduction. Itemized medical deductions are limited to the amount that exceeds 7.5% of the taxpayer's AGI.

Additionally, **under both** federal and state law, health insurance costs include premiums paid for health insurance of the taxpayer, taxpayer's spouse and dependents. A deduction for self-employed insurance costs is not allowed if the taxpayer or taxpayer's spouse is eligible to participate in any employer subsidized health plan. The deduction is limited to the extent of the individual's federal earned income from the business from which the health coverage was established.

Under the PITL, **this bill** would allow as a deduction in determining AGI of 40% the cost of health insurance incurred by a self-employed individual only for taxable years beginning in 1998.

68. S Corporation Elections.

Existing **federal law** provides that if the Secretary determines an S corporation inadvertently made an invalid S corporation election or inadvertently terminates its S corporation election, the corporation shall be treated as an S corporation for the period specified by the Secretary. Qualifying for a determination are those elections ruled invalid because: (1) the election was received by the Secretary 2 1/2 months or more after the start of the corporation's tax year to which the election applies, (2) the corporation did not meet the definition of a "small business corporation" on the date the election was filed, and (3) the corporation did not obtain the consent of all shareholders by the date the election was filed. Inadvertent terminations are limited to terminations because: (1) a corporation ceased to be a small business corporation or (2) a corporation's passive investment income exceeded 25% of the corporation's gross receipts for three consecutive taxable years and the corporation has C corporation earnings and profits. Other stipulations under the inadvertent termination rules require, where applicable, the correction of the cause of the termination or invalid election and the making of any adjustments consistent with the treatment as an S corporation for the period being allowed as an S corporation by the Secretary. All shareholders and the corporation must agree to the adjustments.

A corporation may request a determination of an inadvertent invalid election or termination for any taxable year beginning after December 31, 1982.

Additionally, **federal law** provides for purposes of the application of Subchapter C rules that an S corporation, in its capacity as a shareholder of another corporation, is treated as a corporation. This allows the liquidation of a C corporation into an S corporation to be governed by the generally applicable Subchapter C rules, including rules allowing the tax-free liquidation of a subsidiary into its parent corporation. Following a tax-free liquidation, the built-in gains of the liquidating corporation may later be subject to tax upon a subsequent disposition. An S corporation also is eligible to make an election to treat certain stock purchases as asset acquisitions provided certain other requirements are otherwise met. This results in immediate recognition of all acquired C corporation's gains and losses (and the resulting imposition of a tax) and the benefit of a stepped-up basis in the assets acquired).

California law is prospectively conformed from January 1, 1997, with the federal law allowing the correction of invalid elections. The FTB may allow an S corporation to correct an invalid or late election for income years beginning on or after January 1, 1997, in specified circumstances as provided in federal law. California law also provides that if a federal determination is made regarding a invalid election, allowing the taxpayer to be an S corporation for federal purposes prior to January 1, 1997, the corporation would automatically be considered to be an S corporation for state purposes for its first income year beginning after December 31, 1996. The corporation would be able to revoke its S corporation election under existing provisions in the law.

Additionally, **California law** provides for purposes of the application of Subchapter C rules that an S corporation, in its capacity as a shareholder of another corporation, is to be treated as a corporation. Consequently, an S corporation is able to utilize federal corporate rules relating to tax-free liquidation of subsidiaries and asset acquisitions. California law also provides that an asset acquisition election made for federal purposes would be treated as an election for state purposes. However, if an S corporation did not make an asset acquisition election for federal purposes, the S corporation may make an election for state purposes.

California law also provides that in order for a corporation to be an S corporation for state purposes, the corporation must be a valid S corporation for federal purposes.

For income years beginning on or after January 1, 1987 (the first year California allowed "S" status), **this bill** would allow corporations who did not file a timely federal election to be an S corporation to be treated as an S corporation for state purposes if:

- The corporation and all its shareholders reported their income for California tax purposes on their original returns consistent with S corporation status for the year the election should have been made and all subsequent years.

- The corporation has received notice from the Internal Revenue Service stating that relief was granted under the untimely election provisions (discussed above).

Additionally, for certain stock purchases or asset acquisitions occurring in 1997 and within a income year beginning in 1997, **this bill** would permit a corporation making a federal asset acquisitions election not be bound to the election for state purposes. For income years beginning on or after January 1, 1998, **this bill** would require the S corporation and its shareholders to report certain stock purchases or asset acquisitions for state purposes in the same manner as reported for federal purposes. There will no longer be a federal/state difference in regards to making an asset acquisition election.

Implementation Considerations

Changes required by these provisions would be performed during the department's annual update process.

Fiscal Impact on State Budget

Departmental Costs

These provisions would not significantly impact the department's costs.

Tax Revenue Estimate

Tax revenue losses of $34 million, $29 million and $32 million for fiscal years 1998-99, 1999-00, and 2000-01, respectively.

The following table reflects the estimated impacts of the various provisions of the bill:

		Personal Income Tax			Bank & Corporation Tax		
		(in millions)			(in millions)		
	Description	**1998-9**	**1999-0**	**2000-1**	**1998-9**	**1999-0**	**2000-1**
1	Medicare Plus Choice distributions	(neg.impct)	(neg.impct)	(neg.impct)	-----	-----	-----
2	Hospitals participating in provider-sponsored organizations	(neg. loss)	(neg. loss)	(neg. loss)	-----	-----	-----
3	Deduction for student loan interest	($14)	($15)	($16)	-----	-----	-----
4	Qualified state tuition programs	No Revenue Impact			-----	-----	-----
5	Contributions of computer equipment to schools	-----	-----	-----	($4)	($4)	($4)
6	Cancellation of certain student loans	(minor loss)	(minor loss)	(minor loss)	-----	-----	-----
7	Repeal depreciation adjustment for AMT	($1)	($5)	($8)	(minor loss)	($1)	($1)
8	Repeal of throwback rules	-----	-----	-----	(minor loss)	(minor loss)	(minor loss)
9	Home office deduction	($3)	($8)	($9)	-----	-----	-----
10	Expensing of environmental remediation costs	($1)	($1)	(minor loss)	($6)	($5)	($2)
11	Shrinkage estimates for inventory accounting	(minor loss)	(minor loss)	(minor loss)	($1)	($1)	($1)
12	Timeshare associations	-----	-----	-----	(neg. loss)	(neg. loss)	(neg. loss)
13	Increased deduction of business meals for DOT employees	($1)	($1)	($1)	-----	-----	-----
14	Deductibility of meals provided for convenience of employer	Included in Item 13			-----	-----	-----
15	Modify limits on depreciation of luxury automobiles	-----	-----	-----	(neg. loss)	(neg. loss)	(neg. loss)
16	Suspension of income limit on percentage depletion	-----	-----	-----	($2)	($1)	(minor loss)
17	Mileage deduction for charitable use of auto	($2)	($2)	($2)	-----	-----	-----
18	Receivables purchased by coop hospitals	-----	-----	-----	(neg. loss)	(neg. loss)	(neg. loss)
19	Provide above-the-line deduction for certain business expenses	($1)	(minor loss)	(minor loss)	-----	-----	-----
20	Recognition of gain on certain appreciated financial positions a/	-----	-----	-----	-----	-----	-----
21	Mark-to-market election	Included in #20 above			-----	-----	-----
22	Limitation on exception for investment companies under sec 351	Included in #20 above			-----	-----	-----
23	Gains/losses on terminations of property	-----	-----	-----	$1	$1	$1
24	OID on pooled debt obligations	-----	-----	-----	$10	$11	$11
25	Deny interest deduction on certain debt instruments b/	-----	-----	-----	-----	-----	-----
26	Require gain recognition for certain extraordinary dividends	-----	-----	-----	$10	$2	$2
27	Require gain recognition on certain distributions of controlled stock c/	-----	-----	-----	(minor gain)	(minor gain)	(minor gain)
28	Reform tax treatment of certain corporate stock transfers	-----	-----	-----	(minor gain)	(minor gain)	(minor gain)
29	Treat certain preferred stock as "boot"	-----	-----	-----	$2	$1	$1
30	Holding period for dividends received deduction	-----	-----	-----	(minor gain)	(minor gain)	(minor gain)
31	Reporting of certain payments made to attorneys d/	-----	-----	-----	-----	-----	-----
32	Beneficiaries of estates and trusts returns	(neg. gain)	(neg. gain)	(neg. gain)	-----	-----	-----
33	Registration of confidential corporate tax shelters	-----	-----	-----	$1	$1	$1
34	Extend UBIT rules to second-tier subs and amend control test	-----	-----	-----	(minor gain)	(minor gain)	(minor gain)
35	Basis allocation for partnership property distributions	$3	$2	$2	(minor gain)	(minor gain)	(minor gain)
36	Appreciation of inventory when partnership interest sold	(minor gain)	(minor gain)	(minor gain)	(neg. gain)	(neg. gain)	(neg. gain)
37	Extension of time for taxing precontribution gain				Included in Item 36		
38	Cashout of certain accrued benefits e/	-----	-----	-----	-----	-----	-----
39	Cash in lieu of parking benefits f/	-----	-----	-----	-----	-----	-----
40	Basis recovery rules on annuities	(minor gain)	(minor gain)	(minor gain)	-----	-----	-----
41	Denial of certain amounts paid in connection with insurance	-----	-----	-----	$3	$4	$5
42	Limits on property using income forecast method g/	-----	-----	-----	-----	-----	-----
43	Replacement of involuntarily converted property	(minor gain)	(minor gain)	(minor gain)	-----	-----	-----
44	Exceptions to installment sales rules	-----	-----	-----	$4	$4	$4
45	Charitable remainder trust eligibility	-----	-----	-----	(neg. gain)	(neg. gain)	(neg. gain)
46	Estimated tax safe harbor rules (accelerated payments)	($4)	($1)	($1)	-----	-----	-----
47	Personal transactions & foreign currency gain	(neg. loss)	(neg. loss)	(neg. loss)	-----	-----	-----
48	Simplify formation and operation of international joint ventures	-----	-----	-----	(minor gain)	(minor gain)	(minor gain)
49	Eliminate AMT for children under 14	(neg. loss)	(neg. loss)	(neg. loss)	-----	-----	-----
50	Amount of tax exempt from estimated tax rules (delayed payments) h/	($1)	(minor loss)	(minor loss)	-----	-----	-----
51	Reimbursed expenses of rural mail carriers	(neg. loss)	(neg. loss)	(neg. loss)	-----	-----	-----
52	Travel expenses of Federal employees	(neg. loss)	(neg. loss)	(neg. loss)	-----	-----	-----
53	Look-back method for long-term leases	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)
54	Construction allowances for short-term leases	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)

55	Close of partnership year & deceased partners	(neg. gain)	(neg. gain)	(neg. gain)	(neg. gain)	(neg. gain)	(neg. gain)
56	Reasonable cause exception for penalties	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)	(neg. loss)
57	Statute of limitations on assessments	No Revenue Impact					
58	Estate tax provisions	(neg .loss)	(neg .loss)	(neg .loss)	-----	-----	-----
59	Interest on large corp. underpayments	-----	-----	-----	(neg. loss)	(neg. loss)	(neg. loss)
60	Pension simplification provisions	(neg. loss)	(neg. loss)	(neg. loss)	-----	-----	-----
61	Miscellaneous provisions relating to pensions and other benefits	($2)	($2)	($2)	($1)	($1)	($1)
62	Eliminate ACE adjustment for AMT	-----	-----	-----	($5)	($7)	($11)
64	Workers' comp/personal injury liability assignments	(minor loss)	(minor loss)	(minor loss)	-----	-----	-----
65	UBTI exclusion for sponsorship payments	-----	-----	-----	(neg. loss)	(neg. loss)	(neg. loss)
66	ESOP's conformity to 1995 federal law	($4)	-----	-----	-----	-----	-----
67	Increase health insurance deduction 25% to 40%	($14)	-----	-----	-----	-----	-----
68	"S" Corporation Election Modification	-----	-----	-----	($1)	-----	-----
	TOTALS	($45)	($33)	($37)	$11	$4	$5
	Negligible = Loss or gain of less than $250,000						
	Minor = Loss or gain of less than $500,000						
a/	(#20) Baseline revenue gains of $10 million for 1997-8, $4 million for 1998-9, and $2 million annually thereafter will automatically occur.						
b/	(#25) Baseline rev. gains of $1 mil. annually will automatically occur as taxpayers structure debt instruments in response to the fed. law change.						
c/	(#27) Baseline revenue gains of $7 million beginning in 1997-8 will also occur.						
d/	(#31) Negligible baseline revenue gains annually beginning in 1998-9 will automatically occur.						
e/	(#38) Baseline revenue gains of less than $500,000 annually beginning in 1997-8 will occur automatically for state tax purposes.						
f/	(#39) Baseline revenue gains of less than $500,000 annually beginning in 1997-8 will occur automatically for state tax purposes.						
g/	(#42) Baseline revenue gains of less than $500,000 annually beginning in 1997-8 will occur automatically for state tax purposes.						
h/	(#50) This impact reflects increasing the estimated tax requirements to double the current law ($100 to $200 for married filing joint)						

BOARD POSITION

Pending.

At its March 26, 1998, meeting the Franchise Tax Board considered the Joint Strike Fighter Credit provisions (Item III) contained in this bill that originated in AB 1779 but took no position. Julie Bornstein, on behalf of Controller Kathleen Connell was neutral, Member Dean Andal was in support, and Robin J. Dezember, on behalf of Member Craig L. Brown, abstained.

At its May 28, 1998, meeting, the Franchise Tax Board considered the conformity provisions (Item IV) contained in this bill that originated in SB 1496 and voted 2-0 to support this bill, with Robin J. Dezember, on behalf of Member Craig L. Brown, abstaining.